Business Combinations and Consolidations

1. Key Definitions and Overview

- **Business Combination**: A transaction where an acquirer gains control of one or more businesses (ASC 805).
  - **Acquirer**: Entity obtaining control.
  - **Acquiree**: Business acquired.
  - **Control**: Power to direct significant activities, exposure to variable returns, and ability to affect those returns via power.
- **Consolidation**: Combining financial statements of a parent and its subsidiaries as a single **economic entity** (not separate legal entities) under ASC 810 when the parent has a controlling financial interest.
  - **Parent**: Controlling entity.
  - **Subsidiary**: Controlled entity.
  - **Economic Entity Approach**: Treats the group as one unit, eliminating intercompany transactions to avoid double-counting (Question 10).
- **Practical Insight**: Business combinations include mergers (one entity absorbs another) or acquisitions (purchase without dissolution). Due diligence is critical to assess fair values, impacting tax implications (e.g., asset basis step-up). Consolidation ensures transparency, especially post-Enron with VIE rules.

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2. Acquisition Method (ASC 805)

All business combinations use the acquisition method:

- **Steps**:
  1. Identify the acquirer.
  2. Determine the acquisition date (when control is obtained).
  3. Measure identifiable assets acquired, liabilities assumed, and noncontrolling interest (NCI) at **fair value** (not book value, replacement cost, or original cost minus depreciation) (Question 4).
  4. Recognize goodwill or gain on bargain purchase.
- **Identifiable Assets and Liabilities**: Recorded at fair value on acquisition date.
  - **Example**: Question 4 – Assets/liabilities in a combination are recorded at fair values, not book values or depreciated costs.
  - **Extra**: Fair value is market-based (e.g., price a willing buyer would pay). Intangibles (e.g., patents, customer lists) are recognized if separable or contractual.
- **Pitfall**: Using acquiree's book values instead of fair values is a common error.

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3. Goodwill and Bargain Purchases

- **Goodwill Calculation**: Excess of consideration transferred (purchase price) over fair value of net identifiable assets acquired (FV assets - FV liabilities).
  - **Formula**: Goodwill = Purchase Price - (FV Assets - FV Liabilities).
  - **Bargain Purchase**: If purchase price < FV net assets, recognize a gain in income (rare, often in distressed sales).
- **Examples**:
  - Question 2: Purchase price $900; FV net assets $700 ($900 assets - $200 liabilities) → Goodwill $200.
  - Question 3: Purchase price $4,000,000 (100,000 shares × $40); FV net assets $3,550,000 ($5,000,000 assets + $550,000 adjustment - $2,000,000 liabilities) → Goodwill $450,000.
  - Question 11: Purchase price $600,000; FV net assets $500,000 ($850,000 assets - $350,000 liabilities) → Goodwill $100,000.
- **Goodwill Allocation Methods** (for partial acquisitions):
  - **Full Goodwill Method**: NCI at fair value; includes goodwill for both parent and NCI (common in US GAAP).
  - **Partial Goodwill Method**: NCI at proportionate share of net assets; goodwill only for parent's share.
  - **Example**:
    - Parent buys 80% for $800,000; FV net assets $900,000.
    - **Full Goodwill**: FV of subsidiary $1,000,000 (implied); Goodwill = $1,000,000 - $900,000 = $100,000 (NCI $200,000).
    - **Partial Goodwill**: Parent's share $720,000 (80% × $900,000); Goodwill = $800,000 - $720,000 = $80,000 (NCI $180,000).
- **Extra Insight**: Goodwill is not amortized but tested annually for impairment (ASC 350). High goodwill may indicate overpayment; bargain purchases are rare. Full goodwill method is default in practice.

Table: Goodwill vs. Bargain Purchase

Aspect	Goodwill	Gain on Bargain Purchase
Condition	Purchase Price > FV Net Assets	Purchase Price < FV Net Assets
Recognition	Asset on Balance Sheet	Gain in Income Statement
Subsequent	Impairment Test (No Amortization)	No Further Adjustment
Example	$900 purchase, $700 FV net → $200	$400 purchase, $500 FV net → $100 gain

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4. Consolidation Models (ASC 810)

Two models determine if consolidation is required:

- **Voting Interest Model**:
  - **Control**: Owning >50% of voting shares presumes control, requiring consolidation.
  - **Exceptions**: No consolidation if control is restricted (e.g., foreign government restrictions, as in Question 12) or if noncontrolling shareholders have substantive participating rights (veto over key decisions).
  - **Example**: Question 12 – Majority ownership doesn't guarantee consolidation if foreign restrictions limit control.
- **Variable Interest Entity (VIE) Model**:
  - **Applicability**: When voting rights don't reflect control (e.g., <50% voting but financial control, as in Questions 1, 7).
  - **Primary Beneficiary**: Entity with (1) power to direct significant activities and (2) obligation to absorb significant losses or right to receive significant benefits.
  - **Consolidation**: Required by primary beneficiary, regardless of ownership (Question 1: consolidates even without majority voting; not just loss absorption).
  - **Example**: Question 7 – Consolidation occurs when financially controlled, even without majority voting.
- **Comparison**:

Feature	Voting Interest Model	VIE Model
Basis of Control	>50% voting rights	Economic control (power + exposure)
Ownership Threshold	Typically >50%	Can be <50% or 0% voting
Exceptions	Foreign restrictions, minority rights	None if criteria met
Entity Type	Traditional subsidiaries	Special-purpose entities, trusts
Example	60% ownership, no control → no consolidation	10% ownership, controls VIE → consolidation

- **Extra Insight**: VIEs (e.g., securitization entities) were addressed post-Enron via FIN 46R (now ASC 810) to prevent off-balance-sheet hiding. Assess VIE status if equity is insufficient or voting rights misalign with economics.
- **When to Consolidate** (Question 8): Required if controlling financial interest exists (voting or VIE model). **Not** based on industry homogeneity, large NCI, or significant influence (20-50% → equity method).

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5. Noncontrolling Interest (NCI)

- **Definition**: Equity in a subsidiary not owned by the parent (e.g., 80% parent ownership → 20% NCI).
- **Presentation**:
  - **Balance Sheet**: Separate line in **equity section** (not liability) (Question 6).
  - **Income Statement**: NCI's share of subsidiary's net income/loss shown separately.
- **Measurement**:
  - **Full Goodwill Method**: NCI at fair value (includes goodwill).
  - **Partial Goodwill Method**: NCI at proportionate share of net assets (no goodwill for NCI).
  - **Example**: Parent buys 80% for $800,000; FV net assets $900,000.
    - Full: NCI = $200,000 (20% of $1,000,000 implied FV); Goodwill = $100,000.
    - Partial: NCI = $180,000 (20% × $900,000); Goodwill = $80,000.
- **Losses**: NCI can go below zero if no legal obligation to fund losses.
- **Example**: Question 6 – NCI in equity, impacts both balance sheet and income statement.

- **Extra Insight**: US GAAP allows choice between full/partial goodwill methods; full is more common. NCI disclosures include ownership percentage and income allocation.

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6. Intercompany Eliminations

- **Purpose**: Remove internal transactions to reflect only external activities in consolidated statements.
- **What to Eliminate**:
  - **Profits/Losses**: Unrealized profits in intercompany inventory or fixed asset sales.
  - **Balances**: Intercompany receivables/payables, dividends.
- **What Not to Eliminate**: Profits from external sales (Question 9: Profit on inventory sold to nonaffiliate stays; eliminate gain on asset sale to subsidiary or profit in parent's inventory).
- **Process**:
  - Use consolidation worksheets (not journal entries).
  - Eliminate 100% of intercompany items, even with NCI (adjust NCI for its share).
- **Example**:
  - Parent sells inventory to subsidiary for $100 (cost $80). If unsold by subsidiary, eliminate $20 unrealized profit.
  - **Formula**: Eliminated Profit = Intercompany Sale Price - Cost to Selling Entity.
- **Extra Insight**: Deferred taxes may apply to unrealized profits (e.g., inventory markup). Common error: Forgetting to eliminate 100% of intercompany items or eliminating external profits.

Table: Intercompany Eliminations

Category	Eliminate?	Example
Intercompany Profit	Yes	Profit in inventory sold to subsidiary
Intercompany Balances	Yes	Dividends receivable from subsidiary
External Transactions	No	Profit on sale to nonaffiliate (Q9)

❌ **What Not to Eliminate**

Category	Examples	Why Not Eliminate?
External Transactions	Profit on inventory sold to nonaffiliate	Reflects real economic activity
Third-party dealings	Revenue from outside customers, expenses to vendors	Valid for consolidated reporting

7. Consolidated Financial Statements

- **Entity Accounted For**: Economic entity (parent + subsidiaries), not legal entities or parent alone (Question 10).
- **Preparation**:
  - Include: Parent and controlled subsidiaries (voting or VIE model).
  - Exclude: Associates (20-50% ownership → equity method).
- **Disclosures**:
  - NCI details (ownership, income share).
  - Intercompany eliminations.
  - Segment info (ASC 280) if applicable.
  - Foreign currency translation adjustments (ASC 830) for global firms.
- **Extra Insight**: Consolidated statements combine all controlled entities' assets, liabilities, revenues, and expenses after eliminations. Translation adjustments go to Other Comprehensive Income (OCI), not net income.

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8. Consolidation Worksheet Preparation

- **Purpose**: A tool to combine parent and subsidiary financials, eliminate intercompany items, and allocate NCI.
- **Steps**:
  1. **Combine Financials**: Add parent and subsidiary balances (assets, liabilities, equity, income).
  2. **Eliminate Investment**: Remove parent's investment in subsidiary and subsidiary's equity (common stock, APIC, retained earnings).
  3. **Eliminate Intercompany Items**: Remove intercompany profits, balances, and transactions.
  4. **Allocate NCI**: Reflect NCI's share of subsidiary's net assets and income.

5. **Record Goodwill**: Include goodwill from acquisition.

- **Example Worksheet** (Simplified, based on Question 11):
  - Scenario: Alton buys 100% of Jones for $600,000; FV net assets $500,000; Goodwill $100,000.
  - **Balance Sheet Worksheet** (in $000):

Account	Parent	Jones	Eliminations	Consolidated
Cash	200	50		250
Accounts Receivable	300	100		400
Inventory	400	100		500
PPE (net)	1,000	600		1,600
Investment in Jones	600		(600)	0
Goodwill			100	100
Total Assets	2,500	850	(500)	2,850
Current Liabilities	500	150		650
Long-term Debt	800	200		1,000
Common Stock	400	150	(150)	400
APIC	300	80	(80)	300
Retained Earnings	500	220	(220)	500
Total Liabilities & Equity	2,500	800	(450)	2,850

- **Eliminations**:
  - Dr. Common Stock $150, APIC $80, Retained Earnings $220, Goodwill $100; Cr. Investment in Jones $600.
- **Partial Ownership Example**:
  - If 80% ownership, NCI = $100,000 (20% × $500,000, partial method). Add NCI to equity column.
- **Extra Insight**: Worksheets are exam favorites. Practice adjusting for unrealized profits and NCI. Use consistent formats to avoid errors.

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9. Exam Tips and Common Pitfalls

- **Calculations**:
  - Always use **fair values** for assets/liabilities (not book values).
  - Double-check goodwill: Purchase price - FV net assets.
- **VIE vs. Voting**: VIE applies when voting doesn't reflect control; primary beneficiary needs **power + exposure**.
- **Goodwill**: Positive = asset; negative = gain (rare).
- **NCI**: Equity, not liability; allocate income/loss in income statement.
- **Eliminations**: Remove 100% of intercompany items; don't touch external transactions.
- **Worksheets**: Practice full consolidation entries, especially with NCI and intercompany profits.
- **Pitfalls**:
  - Assuming consolidation for 20-50% ownership (use equity method).
  - Using book values instead of fair values.
  - Forgetting NCI's income statement impact.
  - Eliminating external profits or missing intercompany eliminations.